United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL

75-7051

To be argued by
DAVID SIVE

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P/S

United States Court of Appeals
For the Second Circuit.

FIRST NATIONAL BANK OF HOLLYWOOD, DOROTHY BUCHMAN and SANDER BUCHMAN, as Executors of SAMUEL BUCHMAN, Deceased,

Plaintiffs-Appellees,

against

AMERICAN FOAM RUBBER CORP., MILTON R. ACKMAN, as Trustee of AMERICAN FOAM RUBBER CORP., Bankrupt,

Defendants,

MARIE LOUISE DEMONTMOLLIN, ALEXANDER F. PATHY and SUZANNE M. PATHY,

Defendants-Appellants.

BRIEF FOR DEFENDANTS-APPELLANTS

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

FIRST NATIONAL BANK OF HOLLYWOOD, DOROTHY BUCHMAN and SANDER BUCHMAN, as Executors of Samuel Buchman, Deceased,	:	
Plaintiffs-Appellees,	:	Docket No. 75-7051
-against-	:	
AMERICAN FOAM RUBBER CORP., MILTON R. ACKMAN, as Trustee of American Foam Rubber Corp., Bankrupt,	:	
Defendants,	:	
MARIE LOUISE de MONTMOLLIN, ALEXANDER F. PATHY and SUZANNE M. PATHY,	:	
Defendants-Appellants.	:	

BRIEF FOR APPELLANTS

Preliminary Statement

Defendants-appellants (the "Individual Defendants") ALEXANDER F. PATHY ("Pathy"), SUZANNE M. PATHY ("Mrs. Pathy") and MARIE LOUISE de MONTMOLLIN ("Mrs. de Montmollin")* appeal from a judgment of the United States District Court for the Southern District of New York

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* Mrs. de Montmollin has, since the trial of this action, remarried, and is now known as Marie Louise McKinney. To avoid confusion her older name is kept for purposes of this brief.

(Hon. Irving Ben Cooper), entered December 20th, 1974, granting damages to plaintiffs-appellees ("Buchman") in the amount of $40,868.58 for breach of contract. (259a)*

The contract (the "Buy-Sell Agreement"), dated May 17, 1957, provided for the sale by Buchman of his stock interest in American Foam Rubber Corporation ("AFR" or the "Company"), and an affiliate, Burlington Holding Corporation ("Burlington"), to the Individual Defendants. At the time of the execution of the Buy-Sell Agreement, Buchman, Pathy and Mrs. de Montmollin owned certain AFR and Burlington debentures. Paragraph "SIXTH" (the "Subordination Agreement") of the Buy-Sell Agreement subordinated payment of Pathy's and Mrs. de Montmollin's debentures to payment of those held by Buchman. The Court below has held, in and by its opinion dated July 23, 1969, (195a), reported at 306 F. Supp. 593, that the Subordination Agreement was violated by two transactions, referred to in the opinion as "the Exchange Transaction" and "the Loan Transaction."

The opinion of July 23, 1969 found Mrs. de Montmollin liable to Buchman, but left open for proof by affidavit "the formula upon which damages [were] to be predicated ...." (245a) By an opinion dated September 26, 1969 (247a), reported at 309 F. Supp. 547, the District

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*References to "a" are to the Joint Appendix filed with this Court.

Court ruled that "the computation of the ... specific damages" was to be held "in abeyance until the amount of the dividend to be paid out by the bankrupt estate [of AFR] can be ascertained with a reasonable degree of certainty." (250a)

After determination of the amount of and payment of the said dividend, Buchman moved for summary judgment fixing the amount of the judgment. In an opinion dated November 21, 1974, (257a) not yet reported, the District Court fixed the principal amount of the judgment and the formula for the computation of interest. It directed the entry of judgment, which was entered on December 20, 1974. (259a)

STATEMENT OF THE ISSUES

I.

Did the District Court misconstrue the Subordination Agreement?

II.

Is the discharge of a subordinated debt by a junior creditor, ipso facto, a breach of a subordination agreement?

III.

Did the Loan Transaction constitute "payment" of the debentures?

IV.

Did the District Court commit reversible error in granting judgment, with respect to the Exchange Transaction, on a claim neither pleaded nor proved?

Statement of the Case

This action has a long and tangled history. It began on June 14, 1960, as an action by Buchman against AFR and the Individual Defendants. Buchman alleged that he was the owner of sixty-four of the Company's Series B debentures, each in the principal amount of $1,000. The complaint stated two claims. The first claim, against the Company, alleged failures by the Company to make payments of interest and principal under the debentures, aggregating $28,800.*

The second claim, against the Individual Defendants, the claim now before this Court and hereinafter referred to as the "Subordination Claim"**, was for alleged breach of the Subordination Agreement. In essence, Buchman claimed that an exchange (the "Exchange Transaction") by the Individual Defendants of debentures for shares of preferred stock of the Company (14a) constituted "payment" of the debentures; that the Individual Defendants had "received payment of the amount due, on the debentures held by them in the Corporation... ." (15a-16a), and had"failed to make an equivalent payment to the plaintiff herein of the amounts received by

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* The trustee in bankruptcy of AFR later consented to judgment on this claim and its allowance as a general claim. The claim is not now before this Court.

** The Subordination Claim, as later amended by the Pretrial Order, is set out in the Appendix.(11a) The Individual Defendants' Answer follows it.(18a)

"No claim for interest under the debentures

them, sufficient to retire or purchase the Series B debentures held by plaintiff in the aggregate amount of $64,000.00." (16a)

In July of 1960, the Individual Defendants, before answering, moved under Rule 12(b) F.R.C.P. to dismiss the complaint as against them, on the ground that it failed to state a claim upon which relief could be granted. The motion was denied by District Judge Frederick Van Pelt Bryan. (R 8)* In December 1960, the Individual defendants answered, denying that the transaction alleged in the Subordination Claim constituted "payment", and alleging two affirmative defenses. (R 11)

On January 17, 1961, the Company filed a petition for an arrangement under Chapter XI of the Bankruptcy Act. On February 21, 1961, the Company was adjudicated a bankrupt, and Milton R. Ackman (the "Trustee") was appointed as Trustee in Bankruptcy.

In May 1961 the Individual Defendants moved for leave to interpose an amended and supplemental answer setting forth two separate counterclaims against Buchman, alleging that upon execution of the Buy-Sell Agreement in 1958, Buchman conceived and commenced to carry out, together with salesmen of AFR's Industrial Division, a scheme and plan to destroy the business of the Company, to render it bankrupt, and to

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* The letter "R" denotes the record on appeal, in each case followed by the document number of the index to the record.

acquire its assets for himself upon such bankruptcy. The Trustee, in July 1961, moved to intervene and to interpose an answer asserting a similar claim against Buchman*, as well as a second counterclaim against Buchman and cross-claim against the Individual Defendants.** The motions of both the Individual Defendants and the Trustee were granted in December of 1961, and the pleadings thereafter interposed.

Between 1961 and early 1968 multitudinous and complex discovery and other pre-trial proceedings took place, addressed primarily to the Conspiracy Claims of the Individual Defendants and the Trustee. The pre-trial proceedings culminated in a pre-trial order dated March 15, 1968.

The complexity of the action led to assignment of this case under then Local Rule 2 of the District Court, for all purposes, to Judge Cooper, by order dated August 27, 1964. On June 4, 1965, Samuel Buchman died. His executors, the present plaintiffs, were thereafter substituted for him.

On January 17, 1967, the Individual Defendants moved for summary judgment dismissing the Subordination Claim. The summary judgment motion was denied by Judge Cooper by decision and order dated May 9, 1967 (80a). Judge Cooper

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* This claim by the Trustee and the claims of the Individual Defendants described above are hereinafter referred to as the "Conspiracy Claims".

** The said second counterclaim against Buchman and cross-claim against the Individual Defendants was later dismissed by grant of summary judgment motions made by Buchman and the Individual Defendants. See 250 F.Supp. 60 No further reference is made to this claim in this brief.

A trial was again held to be necessary, however,

construed the Subordination Agreement, and the meaning of "payment", substantially in accordance with the position of the Individual Defendants, but he held that one narrow issue of fact could not be determined without a trial.

> "The plain meaning of the subordination agreement is to prohibit defendants from realizing any cash or its equivalent from the corporation on their debentures until Buchman's debentures had been satisfied in full. . . . It might well be argued, however, that such an exchange could very well be a first step in a plan to obtain cash -- or cash realizable property -- from the corporation. Defendants' papers do not negate this possibility. Until such possibility is excluded, we regard it the better course to await the presentation of evidence at trial. To decide this question of fact by summary procedure is hazardous." (Underscoring supplied) (81a)

By the pre-trial order of March 15, 1968 Buchman amended and supplemented paragraph "SEVENTEENTH" of his complaint to allege two separate transactions, in addition to the Exchange Transaction, as constituting "payment" of the debentures, to wit:

1. a transaction (the "Pathy - de Montmollin Sale") by which Pathy sold to Mrs. de Montmollin debentures in the principal amount of $80,000;

2. the transaction hereinafter referred to as the "Loan Transaction".

The pre-trial order of March 15, 1968 also provided for trial of the Conspiracy Claims separate and apart from and prior to that of the Subordination Claim. It took place

from April 1 to April 29, 1968. There was first tried the issue of liability of Buchman, under the Conspiracy Claims, during which the following question* was submitted to the jury and the following answer given:

> "Did Buchman conspire with important employees of American Foam Rubber Corporation or its subsidiaries to injure or destroy American Foam Rubber Corporation or the value of the individual defendants' investments therein, and were acts committed in furtherance of such conspiracy, and were the defendants damaged by such acts?
>
> (YES) NO" (153a)

Following the jury verdict on the liability issue, the issues of damages suffered by the corporation, and separately by the Individual Defendants, as framed in paragraphs VIII d) and e) of the pre-trial order, were tried and submitted to the jury. The jury returned a verdict in the principal amount of $20,000 in favor of the Trustee, but found that the Individual Defendants did not suffer any damages the pecuniary amount of which it could fix.**

On May 1, 1968, the Individual Defendants renewed their summary judgment motion. The motion was denied by Judge Cooper by decision and order dated August 13, 1968. (R 158)

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* The question was the issue, as stated in paragraph VIII b) of the pre-trial order.

** The Individual Defendants objected strongly to the charge to the jury by Judge Cooper with respect to the measure of damages suffered by the Individual Defendants, and the said charge was the subject of post-trial motions.

In that decision Judge Cooper quoted his principal holding from his earlier decision of May 9, 1967, concerning the meaning of "payment", and applied it to the renewed motion.

The trial of the Subordination Claim by Judge Cooper, without a jury, took place on December 3, 4, and 5, 1968. On July 23, 1969, Judge Cooper rendered his decision, holding that neither the sale by Pathy of debentures to Mrs.deMontmollin, nor the Exchange Transaction, constituted a "payment" of the debentures, or "a first step in a plan to obtain cash or its equivalent from AFR" (218a) Judge Cooper went on to hold, however, that the Exchange Transaction "would have the adverse effect of depriving Buchman . . . of a 'double dividend' out of AFR's bankrupt estate. . . ." (218a) The Exchange, Judge Cooper held, "constituted a breach of the [Subordination Agreement]. . . ."(233a):

> "We hold . . . that where a subordination agreement is in effect, in the absence of provisions to the contrary, it is a breach of that agreement for a junior creditor to discharge the subordinated debt as was done here." (236a)

With respect to the Loan Transaction, Judge Cooper held:

> "We hold that the loan transaction resulted in deMontmollin receiving 'payment' of $15,000 on her Burlington debentures. By the terms of the subordination, she was required to promptly pay that amount over to Buchman. In failing to do so, she breached the subordination provisions of the Buy-Sell Agreement." (240a)

Judge Cooper further held that he was unable to determine the damage resulting from the exchange of debentures for preferred stock. He directed counsel to submit, in affidavit form, proof addressed to that issue. (245a)

On August 5, 1969, the Individual Defendants moved to modify the opinion of July 23, 1969 so as to eliminate therefrom the findings and conclusions with respect to the Exchange Transaction and eliminate the direction to the parties, after the closing of trial, to interpose additional evidence. That motion was denied by Judge Cooper by order dated August 25, 1969. Buchman and the Individual Defendants thereafter did did submit affidavits with respect to the measure of damages. On September 26, 1969, Judge Cooper rendered a decision, reported at 309 F.Supp. 547, holding in abeyance the determination of the damages owed to Buchman on account of the Exchange Transaction and entry of judgment, until termination of the AFR bankruptcy proceedings. (244a)

The amount of the judgment was determined by the District Court, after termination of the bankruptcy proceedings, by way of grant of Buchman's motion for summary judgment, dated September 4, 1974, from which judgment the Individual Defendants now appeal.

The Facts

The Company and the Buy-Sell Agreement.

AFR was incorporated on March 6, 1950 as a New York corporation. (139a) The original investors in AFR included Buchman and Cornelius Egry, the father of Mrs. de Montmollin. Buchman and Egry each acquired a one-third interest in its Class A Common (voting) stock. (139a) From the time of its incorporation, it was engaged in the manufacture of foam rubber products, with its principal plant in Burlington, New Jersey, and executive offices in New York City. (137a) The property in Burlington was owned and leased to AFR by Burlington Holding Corp. (190a) the capital stock of which was held by the owners of the Class A common stock of AFR.(140a) Burlington became a wholly-owned subsidiary of AFR on or about April 30, 1958. (140a)

From the organization of AFR in 1950, until May 17, 1957, the date of the Buy-Sell Agreement, Buchman was its president. (190a) In 1953, Mrs. de Montmollin inherited the stock interest in AFR of her father (140a) and Pathy and Mrs. Pathy each bought a one-ninth interest in its Class A common stock. (140a) In late 1953 Pathy became vice-president, secretary and a director of AFR. (141a) During 1954 and 1955 he gradually increased his time spent with AFR (141a), and in 1956 assumed the office of executive vice president and began to spend substantially his full working time with

AFR, in charge of its retail division. (141a) From 1954 to May 17, 1957, Buchman owned 40% of the Class A common stock of AFR and Pathy, Mrs. Pathy and Mrs. de Montmollin together owned 60%. (141a)

On May 17, ~~1975~~ 1957, the Buy-Sell Agreement was entered into between Buchman and the Individual Defendants. Under it Buchman sold his entire stock interest in AFR and Burlington to the Individual Defendants and resigned as an officer and director. Paragraph "SIXTH" of the Buy-Sell Agreement, the full text of which is quoted in the complaint and the first subparagraph of which is quoted in the July 23, 1969 Opinion,(197a-199a) constituted the Subordination Agreement. AFR's business was thereafter managed by Pathy as president and the other Individual Defendants as officers and directors. (197a)

Until December 1959, the Company's principal source of borrowed funds was The Pennsylvania Company for Banking and Trusts (hereinafter the "Pennsylvania Bank"), which granted loans to the Company of two types: 1) a secured term loan of $400,000; and 2) up to the end of 1957, a revolving loan of $100,000. (156a)

The Exchange Transaction.

Under Buchman the Company had no business dealings with Dun & Bradstreet. (157a) Early in 1958, under Pathy, the Company sought to secure a favorable credit rating from it. (158a) To secure the credit rating it sought

to raise its capital to over a million dollars. (160a) To do so the Company determined to authorize and issue preferred stock in exchange for debentures. (162a)

As stipulated in the pre-trial order, on or about April or May 1958, the Individual Defendants, in their capacities as officers, directors and stockholders of AFR caused the certificate of incorporation of AFR to be amended so as to provide for 3,500 shares of 5% cumulative preferred stock of the par value of $100 each. (198a) Thereafter and in or about May 1958, the defendant de Montmollin surrendered to AFR debentures and notes owned by her in the total face amount of $291,000, and received in exchange therefor 2,910 shares of preferred stock. (162a) In or about December 1959, the defendant de Montmollin surrendered additional debentures and notes in the total face amount of $31,000, and received in exchange therefor 310 shares of preferred stock. (162a)

Other aspects of the background of the Exchange were furnished by Pathy in his trial testimony. In 1956 the capital of the Company was "a little over $400,000."(154a) In May 1957 "it was still less than $500,000." (155a) In late 1957 the Company decided to "increase the capital . . . to get the credit rating, the highest it could get, and thereby also get the highest borrowing capacity for the Company." (156a)

The Exchange was the principal means of raising the capital to over $1,000,000. (160a) As stated by Pathy:

> "To the Company's own capital and retained earnings were added about $300,000 as a result of the exchange of long-term debt which were the debentures, plus $120,000, which were donated by the then-stockholders in form of the stock of Burlington Holding, which was the owner of the real estate. The two amounts, 300 and 120, 420 added to the then-existing capital of AFR, brought the total over $1,000,000, plus . . . ."
> (160a)

No dividend was ever paid by the Company to the Individual Defendants on the shares of preferred stock received in and by the Exchange, or on any other shares of preferred or common stock. (171a) No Individual Defendant ever asked for any such dividend. (171a)

The July 23, 1969 Opinion summarized the evidence with respect to the Exchange Transaction as follows:

> "The corporation never paid any portion of the principal amount owing on Buchman's Series B debentures. (PTO 38) In fact, until some time in 1959 when Walter E. Heller & Co. replaced the Pennsylvania Bank as the main source of financing for the corporation, AFR was prohibited by the terms of the Subordination Agreement with the Pennsylvania Bank from making any payments on account of principal on its Series B debentures. (EX. EN-1, ¶3) Accordingly, no dividends could be declared on the preferred stock since no instalments of principal were paid on Buchman's Series B debentures.
>
> "Redemption of the preferred shares was prohibited by the very terms of the Buy-Sell Agreement: . . .

"It is clear from the foregoing that AFR could not redeem or purchase any of the shares of preferred stock issued to de Montmollin in exchange for her debentures. Further, no dividend payments could be made on said shares unless and until all past due installments of principal on the outstanding Series B debentures were paid. Under such circumstances, we cannot comprehend the exchange as a first step in a plan to obtain cash or its equivalent from AFR." (216a, 217a, 218a)

The Loan Transaction.

In 1958 and 1959 AFR suffered large operating losses, reducing the capital, by late 1959, to below $1,000,000 and threatening the Dun & Bradstreet AA-1 rating. In late 1959 Mrs. de Montmollin exchanged additional debentures for preferred stock (128a -129a) and a Pathy family company paid $120,000 cash for shares of preferred stock.(129a) The purpose of these additional investments was "to bring the capital again over $1,000,000 and thereby retain the AA-1 rating of Dun & Bradstreet."(165a) The Company also sought new financing and negotiations were had in late 1959 with Walter E. Heller & Company ("Heller"), factors, to obtain such new financing.(166a)

On December 29, 1959, a financing agreement was entered into between AFR and its subsidiaries, including Burlington, and Heller.(166a) Heller opened up a term loan of $500,000 to AFR, which was secured by, among other things, a chattel mortgage on the equipment of AFR, and a mortgage on

the plant and property of Burlington. (Ex. FA) All of the AFR companies, including Burlington, guaranteed the payment of the Heller loan and of the advances by Heller under it. (Ex. FA)

In early 1960 the Company continued to suffer large operating losses. (131a) In July of 1960 General Industrial Supply Corporation, a Pathy family Company, lent $25,000 to the Company. (170a) In September of 1960 other family companies of Pathy advanced an additional $40,000 to the Company. (170a)

On April 1, 1960 Burlington debentures owned by Mrs. de Montmollin and aggregating $15,000 in face amount were due and payable. She determined not to seek payment, and surrendered the debentures, receiving a credit of $15,000 on the books of Burlington, which she immediately lent to AFR. She received no cash. The transactions were purely a matter of bookkeeping. As of December 30, 1960, the books of AFR set forth the following information:

"LOANS PAYABLE:

FORMER OFFICER - DUE DECEMBER 30, 1960 -	$15,000.00	
OTHER - DUE DECEMBER 30, 1960	65,000.00	$80,000.00

The loans payable consist of the following:

Mrs. Marie Louise de Montmollin - former officer	$15,000.00
General Industrial Supply Corporation	25,000.00
Pathy Lines, Inc.	20,000.00
Atlantic Commerce & Shipping Co., Inc.	20,000.00
	65,000.00
	80,000.00

(Ex. 36)

The loans described above were represented by 6% notes maturing on December 30, 1960.

At the time of the Loan Transaction, all of the assets of Burlington were mortgaged to Heller under the financing agreement of December 29, 1959. (Ex. FA) At all times from then to the bankruptcy of AFR, Burlington was the guarantor of loans payable by AFR to Heller, aggregating over $500,000. (Ex. FA) The loans were unpaid and owing to Heller as of January 17, 1961, the date of the filing by AFR of its petition for an arrangement, and as of February 21, 1961, when AFR was adjudicated bankrupt. (43a)

POINT I

IN RULING UPON THE EXCHANGE TRANSACTION THE DISTRICT COURT ERRONEOUSLY SUBSTITUTED CONSIDERATION OF GENERAL PRINCIPLES OF SUBORDINATION FOR CONSTRUCTION OF THE SUBORDINATION AGREEMENT.

The terms of the Subordination Agreement, set forth in paragraph "FOURTEENTH" of the complaint, were clear and unequivocal. It consisted of three lettered subsections. Subsection "A", quoted in the July 23, 1969 Opinion, dealt with the relationship of the debentures held by Pathy and Mrs. de Montmollin to those held by Buchman. Subsection "B" dealt with the relationship of certain promissory notes of AFR held by the Individual Defendants to similar promissory notes held by Buchman. Subsection "C" dealt with the relationship of Buchman's AFR and Burlington debentures to indebtedness of the Company to the Pennsylvania Bank.

Subsection "A" consists of two unlettered paragraphs, the first of which defines the rights and duties of the parties. The basic subordination is first stated:

> "The rights of any holder . . . of the debentures . . . held by [Pathy or Mrs. de Montmollin are] subordinated to the rights of any holder of the debentures held by Buchman . . . ."

The extent and limitations of the subordination are thereafter precisely defined. The subordination is "as to payment of interest and principal." (underscoring supplied) The paragraph goes on to provide:

"No claim for interest under the debentures so subordinated shall be made unless all interest payments on the debentures now held by Samuel Buchman shall have been paid in full, and no claim for principal under any of the debentures so subordinated shall be made unless the entire principal of all the debentures now held by Samuel Buchman shall have been paid in full." (12a) (underscoring supplied)

The second unlettered paragraph of subsection "A" prescribes the remedy for breach of the provisions of the first paragraph. The remedy follows precisely the definition of the duty to forbear from the making of claims for interest or principal. It is addressed to the "payment" of interest or principal:

"If for any reason, either corporation shall pay interest or principal on said debentures to any of the buyers, or to any person deriving title to the debentures of said corporation from any of the buyers, and said payment shall be made without first satisfying the priority to which the holder or holders of Samuel Buchman's debentures are entitled by reason of the foregoing provisions, the amount or amounts of the payment so made to the Buyer (or to the person deriving title from her or him) shall be promptly paid by such Buyer to said holder or holders of Samuel Buchman's debentures." (12a) (underscoring supplied)

The matter of the proper construction of the Subordination Agreement was placed before the District Court three times, twice by summary judgment motion and the third time by the trial. In his first ruling upon the meaning of the Subordination Agreement, Judge Cooper determined the "plain meaning of the subordination". That "plain meaning", he said, was "to prohibit [the individual] defendants from

realizing any cash or its equivalent from the corporation on their debentures until Buchman's debentures had been satisfied in full." (81a) (underscoring supplied)

Judge Cooper denied the first summary judgment motion, because it was not absolutely clear from the papers before him that the Exchange Transaction was not "a first step in a plan to obtain cash -- or cash realized property -- from the corporation. The Individual Defendants, approximately a year later, and upon additional papers proving that the Exchange Transaction could not have been such "a plan to obtain cash -- or cash realized property -- . . .", renewed the summary judgment motion. Judge Cooper again considered the Subordination Agreement. In his opinion (R 137) he referred to, quoted and reaffirmed his earlier construction as to its "plain meaning". He then referred to the amendment of the Complaint, in and by the pre-trial order, "to add two additional transactions alleged to have breached the subordination agreement . . . ."

To the Exchange Transaction and the two additional transactions, he applied the same test, dictated by his own earlier ruling, as to the "plain meaning of the subordination agreement":

> "Applying the tests set out in our prior memorandum to the exchange transaction as well as to the two new claims added by the Pre-Trial Order, we conclude that defendants have not excluded the possibility that the transactions complained of might be steps 'in a plan to obtain cash -- or cash realizable property -- from the corporation.'" (R 137)

A trial was again held to be necessary, however, for the limited purpose of determining the one issue of fact, whether "the transactions complained of might be steps 'in a plan to obtain cash -- or cash realizable property -- from the corporation.'"

On the trial Buchman's counsel adduced no testimony. His prima facie case consisted of facts stipulated in the pre-trial order, the marking in evidence of certain documents referred to in the pre-trial order, and short extracts from the pre-trial testimony of Pathy. The Individual Defendants adduced the testimony of Pathy and placed in evidence a number of documents, consisting substantially of those previously made a part of their summary judgment motions.

In his opinion of July 23, 1969, Judge Cooper first held that the Subordination Agreement was not violated by the first of the three transactions pleaded as constituting payment of the debentures, the Pathy-deMontmollin sale. He then proceeded to determine the legal consequences of the Exchange Transaction, applying his own construction of the Surbordination Agreement, the law of the case. He held that:

> "It is clear from the foregoing that AFR could not redeem or purchase any of the shares of preferred stock issued to de Montmollin in exchange for her debentures. Further, no dividend payments could be made on said shares unless and until all past due installments of principal on the outstanding Series B.debentures were paid. Under such circumstances, we cannot comprehend the exchange as a first step in a plan to obtain cash or its equivalent from AFR."(218a)

The holding that the Exchange could not be comprehended "as a first step of a plan to obtain cash or cash realizable property -- or actually constituted the realization of cash or its equivalent -- from AFR", should have been followed by a ruling dismissing the Subordination Claim, insofar as it rested upon the Exchange Transaction. What followed, however, was not such a ruling, but an essay by the Court on subordination as a generic subject of law.

After extensive consideration of two cases* dealing with certain other specific and very different fact situations and differently worded subordination agreements, and several law review articles dealing with many different types and features of subordination agreements, Judge Cooper held that:

> ". . .[D]ischarge of the subordinated debt itself most certainly constitutes a breach of the subordination." (233a)

Point II of this brief demonstrates, the Individual Defendants submit, the invalidity of such a rule of law, under the very cases and other authorities cited. Wholly apart, however, from the correctness or incorrectness of the statement as a principle of law, the ruling was part of a substitution of legal scholarship, as applied to different situations and different agreements, for the Court's own thrice-stated

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* In Re Dodge-Freedman Poultry Co., 148 F.Supp. 647 (D.N.H.1956), aff'd sub nom. Dodge-Freedman Poultry Co. v. Delaware Mills, Inc., 244 F.2d 314 (1st Cir. 1957); In Re Cherno v. Dutch American Mercantile Corp., 353 F.2d 147 (2d Cir. 1965).

construction of the Subordination Agreement between Buchman and the Individual Defendants. In so doing, the District Court did what the authorities say should not be done. It construed the meaning of the agreement according to a label, rather than its language. As stated by this Court in Pan-American Bank & Trust Co. v. National City Bank, 6 F.2d 762, 766 (2d Cir. 1926):

> ". . .[I]t is clear that the legal effect of what men do is not determined by the names they affix to their acts. The essential nature of their acts determines, and the law has its own names for the results they achieve . . . (citation omitted)"

As stated by another Court of Appeals:

> ". . . 'what a contract is styled by the parties does not determine its character or their legal relationship'."
> Schroeder v. Pennsylvania R. Co., 39 F.2d 452, 455 (7th Cir. 1968) (citation omitted)*

The determination of the rights of the parties by the language of their Agreement, rather than its label, is of special importance in this actior. The District Court's Exchange Transaction ruling took place twelve years after the date of the Buy-Sell Agreement and was based upon cases reported and law review articles written in the 1960s, likewise several years after the Buy-Sell Agreement. To the extent that the parties may be deemed to have incorporated the law of subordination in the Buy-Sell Agreement, the law incorporated was the law as of 1957.

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* Accord, City Stores Co. v. Lerner Shops of District of Columbia, Inc., 410 F.2d 1010, 1015 (D.C. Cir. 1969); Inman v. Binghamton Housing Auth., 3 N.Y. 2d 137, 164 N.Y.S. 2d 699 (1957); Columbus Cosmetic Corp. v. Shoppers Fair of South Bend, Inc., 26 App. Div. 2d 391, 275 N.Y.S. 2d 135 (1st Dept. 1966).

The most basic rule of construction requires that the language used in a contract be given its commonly accepted meaning unless the circumstances clearly show a different intention. In Eddy v. Prudence Bonds Corp. 165 F.2d 157 (2d Cir. 1947), Judge Learned Hand wrote:

> ". . .[W]e must consider the words themselves for they are always the most important evidence of the parties' intention." Id. at 161 (underscoring supplied)

In Laba v. Carey, 29 N.Y. 2d 302, 327 N.Y.S. 2d 613 (1971), the New York Court of Appeals stated the same principle:

> ". . .[W]e are required to adjudicate [the parties'] rights according to the unambiguous terms of their contract and therefore must give the words and phrases employed their plain meaning." Id. at 308.

See also, Mencher v. Weiss, 306 N.Y. 1, 114 N.E. 2d 181 (1953).

The intention of the parties to the Subordination Agreement is clear. They forbade payment of interest or principal on the debentures held by Pathy and Mrs. de Montmollin, unless all interest or principal, as the case might be, were paid on the debentures held by Buchman. In the event of violation of such prohibition, a specific remedy was provided. The amounts of any payments of interest or principal made in violation of the prohibition were to be promptly paid over by the holder of the Pathy or de Montmollin debentures to the holder of the Buchman debentures.

The District Court in holding, on the basis of its views of the general law of subordination, that the Exchange Transaction, which the Court itself held was no "payment", violated the Agreement, defied the language of the first paragraph of subsection "A". The Court's later holding that damages could be measured by the amount that the dividend in bankruptcy would have been on the debentures exchanged defied the language of the second paragraph. That second paragraph prescribed the sole and exclusive remedy for breach of the Agreement. In McCready v. Lindenborn, 172 N.Y. 400, 65 N.E. 208 (1902), the New York Court of Appeals set forth the rule which is clearly applicable here:

> "When the parties by their contract provide for the consequences of a breach, lay down a rule to admeasure the damages, and agree when they are to be paid. The remedy thus provided must be exclusively followed." Id. at 409.

McCready is cited by this Court for the same principle in In Re Hale Desk Co., 97 F. 2d 372 (2d Cir. 1938).

The remedy provided by the Subordination Agreement for any breach of it follows immediately after the definition of the Individual Defendants' duties. The provision prescribing the remedy is, by its very language, inclusive of any and all violations of Buchman's priority of payment. It is unquestionably aimed at all incidents of default. The District Court violated the Subordination Agreement's plain terms by prescribing a different remedy.

POINT II

THE DISTRICT COURT ERRED IN HOLDING THAT IT IS A BREACH OF A SUBORDINATION AGREEMENT FOR A JUNIOR CREDITOR TO DISCHARGE A SUBORDINATED DEBT

The July 23, 1969 opinion, after holding, correctly, that "the exchange [was not] a first step in a plan to ascertain cash or its equivalent from AFR", proceeds to discuss the law of subordination under the caption, "Dividends Paid on Subordinated Debt". The discussion begins as follows:

> "While the exchange transaction did not result in deMontmollin receiving 'payment' (as that term was used in the subordination provisions) of interest or principal on her debentures, it did have the adverse affect of depriving Buchman, and now his executors (the plaintiffs (herein), of a 'double dividend' out of AFR's bankrupt estate--i.e. the dividends paid on the senior debt and, by reason of the subordination provisions, the dividends paid on the subordinated debt." (219a) (footnote omitted)

The discussion ends with the statement of a broad and new principle:

> "We hold . . . that where a subordination agreement is in effect, in the absence of provisions to the contrary, it is a breach of that agreement for a junior creditor to discharge the subordinated debt as was done here." (236a)

The District Court acknowledged that "[t]he authority that exists [is] scant.. . ."(222a) The "scant" authority consists of two cases:

> In Re Dodge-Freedman Poultry Co., 148 F.Supp 647 (D.N.H. 1956), aff'd sub nom., Dodge-Freedman Poultry Co. v. Delaware Mills, Inc., 244 F.2d 314 (1st Cir. 1957);
>
> In Re Cherno v. Dutch American Mercantile Corp., 353 F.2d 147 (2d Cir. 1965).

The Individual Defendants submit that the opinion misconstrues the cases and that, properly construed, they not only support, but require, a holding that the Exchange Transaction did not violate the Subordination Agreement.

In Dodge-Freedman, supra, that company filed an arrangement petition on January 31, 1955. On April 15, 1955, Ann Freedman filed her proof of claim in the amount of $51,000,000. After acceptance by the creditors of a plan for arrangement, but before its confirmation by the court, Ann Freedman

> "filed an affidavit under General Order 41 of the Bankruptcy Act, waiving any and all rights to share in the deposit made by the debtor to cover its obligations and to share in any dividend under the plan." (148 F. Supp. at 648.)

Ann Freedman was the wife of Harry Freedman, president, clerk, director and principal stockholder of the debtor. Delaware Mills, Inc., a creditor which had filed a claim in the amount of $42,594.63, was entitled under

the plan of arrangement to fifteen percent thereof, "leaving a balance of $36,205.44."

> "On this unpaid balance, Delaware Mills, Inc. filed another proof of claim, asserting its right to an additional dividend of $7,500 by virtue of a subordination agreement duly executed on May 11, 1954, between itself and Harry Freedman." (148 F. Supp. at 648).

The debtor, controlled by Harry Freedman, objected to the allowance of Delaware Mills' additional claim. The Referee in Bankruptcy, as described by the reviewing court, refused

> "to give 'judicial sanction to an unconscionable, unjust, inequitable and deliberate act of avoidance,' ruling that Freedman was estopped from voluntarily waiving the dividend due under the Plan of Arrangement. He found that the subordination agreement is and always was an equitable assignment of his claim by Freedman to Delaware Mills, Inc. Invoking the equity powers of the Bankruptcy Court, he ordered the Debtor deposit $7,500 as an additional dividend for Delaware Mills, Inc." (148 F. Supp. at 649) (underscoring supplied).

The U.S. District Court for New Hampshire thereupon ruled that the Referee had erred in holding that the subordination created an equitable assignment. The Court further ruled that the subordination did not create an equitable lien. It held that Delaware, nevertheless, was

"entitled to receive the dividend", because the Bankruptcy Court, as a court of equity,could disregard the provisions of the agreement, under which "Freedman had no duties to perform other than to forbear," and look to "the spirit of the agreement" (148 F. Supp. at 651). The spirit of the agreement barred Freedman from preventing the satisfaction of Delaware's claim by the "unconscionable, unjust, inequitable and deliberate act of avoidance" of waiving his right to a dividend. Harry Freedman, the court ruled, held the right to collect the dividend as "a constructive trustee" for Delaware.

The District Court herein was not a court of equity. The Bankruptcy Court administering the bankruptcy estate of AFR was a court of equity. In that bankruptcy proceeding the claims of Mrs. de Montmollin on her debentures not exchanged for preferred stock and on certain notes, as well as on the loan which is involved in the Loan Transaction hereinafter discussed, were assigned, and the dividends thereon paid, to Buchman. Mrs. de Montmollin never raised any question concerning that. The Exchange Transaction, taking place three years before the bankruptcy, was not, however, an "unconscionable, unjust, inequitable and deliberate act" designed to reduce Buchman's bankruptcy dividends. It was part of a plan to increase the capital of the Company, for legitimate and important business purposes

of interest to Buchman as well as to the Individual Defendants. The Exchange Transaction also, ironically, took place at the very time when Buchman was carrying out his scheme to destroy the business of the Company. (153a)

The test of Buchman's rights herein with respect to the Exchange was the terms of the Subordination Agreement, not concepts of equity at the time of the bankruptcy. If, however, "equity" were made the test, surely equity should not penalize Mrs. de Montmollin for surrendering debt for stock, and increasing the capital of the Company, at a time when there was no contemplation of bankruptcy, except perhaps by Buchman, then scheming and acting to bring about AFR's bankruptcy. Buchman, now the purported seeker of equity, was bound to do equity. Cherno, supra.

Dodge-Freedman, supra, is not authority for the proposition that "it is a breach of [a subordination agreement] for a junior creditor to discharge the subordinated debt as was done here. (236a) The holding of Dodge-Freedman that the Referee was wrong in ruling that the "subordination agreement is and always was an equitable assignment" is, to the contrary, consistent with the reservation of the rights of the junior creditor to deal with his claim, including the right to discharge the claim without receiving any payment therefor, so long as the discharge is not the kind of inequitable and fraudulent conduct which requires a court of equity to hold

that the junior creditor is estopped.

In Cherno, supra, this Court of Appeals also rejected the propostion that a subordination agreement, as such, creates an equitable assignment of the subordinated claim, reversing a District Court holding that it did. The "proposition" that the senior creditor "receive[s] an equitable assignment must find support in the express terms of the subordination agreement or the proposition fails." (353 F.2d at 151). Construing the terms of the subordination agreement then before it, this Court held that the junior creditor "Blanmill", had

> "agreed to do no more than defer its claim until the Dutch American note was paid with interest. Absent a manifestation of intent to make an assignment of the chattel mortgage by the terms of the agreement or otherwise, a subordination agreement does not constitute an equitable assignment of the security." (353 F. 2d at 151).

This Court, in Cherno, did state, as the District Court herein has noted (231a), that Blanmill had breached an agreement of subordination. The significance of that statement must, however, be determined by the terms of Blanmill's agreement and the acts constituting the breach. The terms of Blanmill's agreement were stated as follows:

"On October 23, 1959, Blanmill Realty Corp. loaned $87,000 to Itemlab, Inc., evidenced by Itemlab's note in that amount and secured by a chattel mortgage, which was duly filed in the office of the Town Clerk of the Town of North Hempstead, New York, in compliance with the provisions of §230 of the New York Lien Law. Thereafter, when Itemlab was in default on its note to Blanmill and in need of additional cash, Itemlab, Blanmill and Dutch American entered into a written subordination agreement which provided that Dutch American would loan Itemlab $50,000, on its note to Dutch American in that amount, with the express understanding that Blanmill's claim against Itemlab 'shall . . . be subject and subordinate in lien to the lien of said note for $50,000.' and that 'no part of the indebtedness . . . shall be paid [to Blanmill] until all sums due and owing to Dutch American Mercantile Corp. shall have been paid and disposed of." (353 F.2d at 149).

The conduct constituting the breach is described correctly, as far as it goes, in the July 23, 1969 opinion of the District Court below.

"Itemlab defaulted on its note to Dutch American, and the latter commenced an action to recover the amount due. While that case was pending, Blanmill 'executed and filed a satisfaction of the chattel mortgage in spite of the fact that no part of the mortgage debt had ever been paid.'" (229a, 230a)

That description does not, however, go far enough. This Court, in the Cherno case itself, described the conduct more fully:

"Itemlab defaulted on its note, and Dutch American commenced an action to recover the amount due. While that case was pending, Blanmill, as a part of a scheme to get additional cash for Itemlab, executed and filed a satisfaction of the chattel mortgage in spite of the fact that no part of the mortgage debt had ever been paid. At the same time that the satisfaction of mortgage was filed, and in furtherance of the scheme, a new chattel mortgage on the same property was made to secure a note for a

On March 5, 1968, the Individual Defendants

> loan in the amount of $47,300 and delivered to an innocent lender, the 18th Avenue Land Corp., which recorded it." (353 F. 2d at 149) (underscoring supplied)

Cherno, therefore, stands not as authority for the proposition for which the District Court in this action cited and quoted it, but for the proposition that a fraudulent scheme by a junior creditor to cancel a security interest of a senior creditor, when the debtor was in default in payment of the indebtedness to the senior creditor and an action by the senior creditor was pending for the amount due, was a violation of that junior and senior creditor's particular subordination agreement.

Cherno is also authority for the proposition that a party to a subordination agreement who seeks equity must do equity, this Court holding that Dutch American, seeking equity from this Court on the basis of Blanmill's "scheme to get additional cash for Itemlab", had itself not done equity. It denied Dutch American the relief it sought.*

By its rejection of the equitable assignment theory

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* Dutch American's own inequitable conduct , far transcended by Buchman's conspiracy, was described as follows:

> "As far as innocent third persons were concerned, Dutch American left it within the power of Blanmill to release the mortgage at any time without notice of any claim of interest on the part of Dutch American, which had an equitable duty to give notice to third persons, who might be dealing with Itemlab, that it asserted an equitable claim against the chattels either directly or via Blanmill's mortgage." (353 F. 2d at 155).

of the remaining issues of fact raised

of subordination, Cherno, as well as Dodge-Freedman, supra, is authority for the proposition that the rights and privileges of ownership of the subordinated claim remain with the junior creditor in the absence of default.* One of those rights is the right of releasing the claim in a transaction having legitimate business purposes.

Some authorities have likened subordination to guaranty, and the junior creditor to a guarantor. The District Court noted:

> "A subordinator has been referred to as 'a guarantor to the extent of the value of the subordinated debt'. Calligar, supra note 9 at 394." (234a, N. 51)

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*The equitable assignment theory is discussed in the principal of several law review articles cited by the District Court. Calligar Subordination Agreements, 70 Yale L.J. 376, 388, 386 (1961). The theory is said to have been used in only one case, In Re Handy-Andy Community Stores, Inc., 2 F. Supp. 97 (W.D. La. 1932), in which the senior creditor claimed to be entitled to receive dividends on the subordinated claims. Those individual creditors had specifically agreed, in case of bankruptcy, to file claims and assign them to the senior creditor. The senior creditor was permitted to prove the claims in the absence of a legal assignment thereof by the junior creditors.

individual defendants by

Assuming, however, arguendo, under the District Court's interpretation of the Subordination Agreement, that Mrs. de Montmollin was a guarantor of payment of Buchman's debentures, to the extent of the value of the dividend in bankruptcy she would have received had she not participated in the Exchange Transaction, the assets of AFR and Burlington provided the collateral since in bankruptcy, Buchman was to look to the assets of the company to satisfy his debentures. Buchman's conduct in conspiring with others to destroy the business of AFR substantially reduced the value of its assets and concomitantly reduced the possibility that AFR would ever be able to fully satisfy his debentures.

That impairment of the "collateral" by Buchman, released the guarantor, Mrs. de Montmollin, from her obligations to satisfy the unpaid balance on Buchman debentures. Cf. Royal Business Funds Corp. v. Ehrlich, ___ Misc. 2d ___, 356 N.Y.S. 2d 407 (Sup. Ct. N.Y.Co. 1974), aff'd, ___ App. Div. 2d ___, 356 N.Y.S. 2d 1015 (1st Dept. 1974); Sterling Factors Corp. v. Freeman, 50 Misc. 2d 715, 271 N.Y.S. 2d 715 (Sup. Ct. Nassau Co. 1966), aff'd, 27 App. Div. 2d 956, 279 N.Y.S. 2d 577 (2d Dept. 1967).

In ruling upon the correctness or incorrectness of the rule of law pronounced by the District Court - "discharge

[by a junior creditor] of the subordinated debt itself most certainly constitutes a breach of the subordination" - this Court may consider not only the applicability of such a principle to the particular facts of this case, including the fact that Buchman was at the time of the Exchange embarked upon his scheme to destroy the business of the Company, but its applicability to literally thousands of routine transactions now carried on by the business and financial community.

Thousands of bank loan agreements contain or are accompanied by a subordination of indebtedness of the borrower company to principals of such company, to the indebtedness created by the loan. Applying the District Court's rule of law, unless specifically provided otherwise, no principal of such a company may forgive such indebtedness of the Company to him, even if the principal purpose thereof is to drastically improve the financial strength and credit rating of the company, without running the risk that the bank will at some time thereafter sue him for damages measured by the dividend on a general claim in the amount of the forgiven debt, in some later bankruptcy or other debtor relief proceeding.*

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*The availability of such a claim to the bank would pose fascinating but troublesome problems to bank counsel. Should they sue immediately upon learning of the release regardless of the condition of the company? Is such a claim premature before a bankruptcy or before it is known whether there will be a dividend, and if so in what amount? Does the applicable statute of limitations begin to run only upon such bankruptcy or upon the payment of the dividend, or does it begin to run immediately upon the forgiveness of the debt or the beginnings of the downfall or participated downfall of the Company? If bank counsel are

What has been said about routine bank loan agreements with subordinations would apply to large numbers of other subordination transactions, too numerous for discussion in this brief. Where subordination agreements are now silent they would have to provide, in each case in which it is contemplated that the junior indebtedness may be forgiven or otherwise discharged, in whole or in part, for the consequences of each such discharge.

Neither this Court nor the District Court should, of course, hesitate to promulgate a rule of law merely because it would create a new set of difficult problems for whole segments of the business and financial community, or any other community. If the court is to do so, however, it is submitted that this case is not the proper case, on either the facts or the equities. The Individual Defendants acted in good faith; they had no intention of prejudicing Buchman. They did not contemplate bankruptcy. Buchman, on the other hand, was pursuing his scheme to destroy the business of the Company. Equity hardly demands that he be the first beneficiary of a new rule of the law of subordination.

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cautious, and in the absence of clear authority permitting their waiting until bankruptcy or threatened bankruptcy, suit would be instituted upon learning of the forgiveness. Would judgment in each suit be postponed until the bankruptcy is terminated and the amount of the dividend determined?

POINT III

THE LOAN TRANSACTION DID NOT RESULT IN ANY PAYMENT OF ANY OF THE DEBENTURES.

In its determination of the legal effect of the Loan Transaction, the District Court purported to ground its ruling upon the "payment" language of the Subordination Agreement and the "payment" theory of the complaint. The ruling is in conflict with its own thrice made holding that the transaction could not be deemed a "payment" unless it was "a first step in a plan to obtain cash or its equivalent." (214a)

The facts were undisputed, as to what Mrs. de Montmollin's "plan" was. The plan is clear from the testimony of Pathy, on his direct examination, concerning the financing agreement entered into between AFR and Heller in December 1959.

> "Q Could you, Mr. Pathy, tell us what if anything you said at or about when to Heller with respect to the issuance of additional shares of preferred stock?
>
> * * * * *
>
> "A I informed Heller that we decided to increase the capital of AFR to over $1 million so as to retain our AA-1 rating with Dun & Bradstreet.
>
> "Q Other than the exchange of debentures for shares of 300,000, the donation of Burlington

stock for 120,000 and the sale and purchase of additional shares of preferred stock at the end of December '59, were any other loans, advances or investments made by you or Mrs. de Montmollin between March '58 and December 1960?

"A Yes.

"Q Could you describe very briefly the approximate amount, the nature of each such loan or advance or investment and the approximate date, if you can, without refreshing your recollection?

"A In December of 1959 Mrs. de Montmollin exchanged a note of $25,000 for preferred shares. In July of 1960, General Industrial Advanced AFR first 5,000, then another $25,000.

In August or September of 1960 I caused two companies in which I had family contacts to advance to AFR $40,000, and going back, in April of 1960, Mrs. de Montmollin, who was supposed to receive $15,000 on her A bond Burlington debentures did not receive $15,000 on those bonds, but loaned those $15,000 to AFR." (159a, 160a, 161a)*

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*Pathy further testified:

"Q You heard testimony here about the loan to officer -- I think that is the term -- of $15,000 set forth on a report of Edward Isaacs, a copy of which has been marked in evidence by the plaintiffs, specifically Exhibit 35.

Do you see the entry on Exhibit 35 entitled 'Loan Payable Officer, $15,000'?

"A Yes.

"Q Who is that officer?

"A Mrs. de Montmollin.

"Q And how did the $15,000 entry come about?

"A She had Burlington Holding bonds or debentures which mature in April of 1960. By that time Burlington was a subsidiary of American Foam. The same amount of $150,000 which were supposed to be paid to her but were not paid, were loaned by her to AFR, and therefore it became a loan of an officer to AFR.

Footnote continued on following page

In essence there was an exchange of debenture indebtedness of Burlington, a wholly owned subsidiary wholly managed and controlled by and actually an alter ego of AFR, for indebtedness of AFR. It can hardly be claimed that the AFR indebtedness was "cash". Nor

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Footnote continued from preceding page:

"Q Was any amount ever paid to Mrs. de Montmollin on that loan?

"A No.

"Q Was any cash or any property ever paid or transferred to Mrs. de Montmollin on account of that $15,000 Burlington debenture?

"A No.

"Q Was any cash realizable property ever paid to her for that?

"A No.

"Q Did she ever ask for it?

"A No.

"Q Did she ever mention it to you?

"A No.

"Q Did the company ever consider paying any cash or cash realizable property to her for that $15,000 debenture?

"A No.

"Q Is that 15,000 indebtedness owed by the company now?

"A Yes." (183a, 184a)

was it the "equivalent" of cash any more than the indebtedness of Burlington was such. Neither was it "cash realizable property" because there never was any plan or any thought of any plan to realize cash. The plan of the Individual Defendants and the whole course of the transaction from late 1959 until the Company was forced to file its Chapter XI petition in January 1961 was to do the opposite -- to put additional moneys into the Company to protect its capital and cash position against the severe operating losses that the Company suffered in 1958, 1959 and 1960, while Buchman was carrying on his conspiracy.*

*The clearest summary of the transactions is set forth in the Pathy affidavit of March 1968 in support of Individual Defendants' second summary judgment motion at pages 35-41, a portion of which is set forth below:

> "53. The loans made in 1960, described above, brought the total investments in the Company, since May 1957, by the INDIVIDUAL DEFENDANTS to $635,000. A breakdown of the total amount follows, by date, nature of investment, and amount:

Date	Nature of Investment	Amount
May 27, 1958	the Exchange	$300,000
May 27, 1958	donation of Burlington stock	120,000
December 29, 1959	purchase of additional shares of preferred stock	145,000
July 25, 1960	Loan	25,000
July 27, 1960	Loans	40,000
August 3, 1960	Loan	5,000
		$635,000

Footnote continued on following page.

Part of that protection of the capital and cash position of AFR, whose indebtedness to Heller was secured by a mortgage of all of the real property of Burlington and guaranteed by Burlington, was the refusal to take any payment. Only in the purest technical sense, equating "payment" with legal discharge, was Mrs. de Montmollin receiving any payment. Tha purely technical construction of the term "payment", however, was precisely the construction ruled out by the Court itself on the two summary judgment motion rulings and in the part of the opinion of July 23, 1969 holding that the Exchange Transaction was not "payment".(213a)

Footnote continued from preceding page:

> "Not one dollar of the said investments has been repaid to the INDIVIDUAL DEFENDANTS, by way of interest, return of principal, dividends, or redemption or purchase of stock. Nor is there any possibility of any recovery from the Company of any of the amounts invested in the preferred stock, aggregating $565,000. On the $70,000 in loans there may be a small dividend from the bankruptcy estate.
>
> "I also want to point out to this Court that, in addition to the investments described above, the INDIVIDUAL DEFENDANTS paid to BUCHMAN, between May 17, 1957 and January 2, 1959, for the shares of common stock of AFR alone, which they bought from BUCHMAN under the Buy-Sell Agreement, the total amount of $183,220." (132a, 133a)

same manner as it would be bound by the doctrine of res

POINT IV

THE DISTRICT COURT COMMITTED REVERSIBLE ERROR IN DETERMINING THE SUBORDINATION CLAIM UPON A THEORY OF LAW NEITHER PLEADED NOR TRIED.

From his first pleading of his complaint in this action, through two summary judgment motions, amendments and supplements by Buchman of his pleading permitted by a pretrial o der, and the trial of this action, all taking place over the course of eight and one-half years, Buchman alleged one theory of liability of the Individual Defendants -- the "payment" theory. That theory, stated in paragraphs "EIGHTEENTH" and "NINETEENTH"* of the complaint, never changed from commencement of this action to final judgment.

The District Court determined the "payment" issue in favor of the Individual Defendants. The Court, however, on its own motion, proceeded to:

1. Consider and rule, eight months after the close of trial, upon wholly new issues involving a theory of action never pleaded;

2. Reopen the trial and direct the parties to submit additional evidence, by affidavit, addressed to the new issues, overruling the Individual Defendants' objections, made by motion, to such reopening and direction;

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* The pretrial order amended paragraph "SEVENTEENTH" only, by adding the Loan Transactior and the Pathy-de Montmollin Sale to the Exchange Transaction.

3. Receive such evidence directed to the new issues;

4. Determine that it could not determine the amount of damages, if any, owed to Buchman as a result of the Exchange Transaction, until the termination of the AFR bankruptcy proceedings; and

5. Grant judgment five years later upon such termination and post-trial summary judgment motion by Buchman.

That such procedures were unprecedented is not reason enough, standing alone, to rule them invalid. That they were utterly unauthorized by the Federal Rules of Civil Procedure or by any concept of fair and due process, and substantially prejudiced the Individual Defendants, constitutes sufficient additional reason to do so and reverse the Court below. An understanding of both the novelty of the procedures and the prejudice suffered by the Individual Defendants requires a description of some aspects of the proceedings not furnished in the "Statement of the Case."

When the Individual Defendants made their first summary judgment motion to dismiss the Subordination Claim on January 7, 1967, they also sought alternative relief,

"2. Specifying the material facts, with respect to the said second cause of action, which appear without substantial controversy, and providing for a separate trial, without a jury, of the remaining issues of fact raised by the said second cause of action, and the said answer thereto, upon such early date, in advance of the trial of the other causes of action and claims remaining to be tried in this action, as this Court may fix." (R 131)

The motion papers consisted primarily of a detailed account by Pathy of the Exchange Transaction, annexing many of the documents relating thereto which were later marked as exhibits on the trial. With respect to the alternative relief sought, the moving affidavit of David Sive, Esq. stated:

"If . . . this Court believes that some aspect of the narrow issue of construction must be tried such trial can be had immediately and can probably take no longer than one trial day. Any aspect of this single narrow issue is in sharp contract to the number and complexity of the issues of fact posed by the INDIVIDUAL DEFENDANTS' two counterclaims and by the parallel first counterclaim interposed by the TRUSTEE.. .. These three claims . . . involve charges of a conspiracy which BUCHMAN conceived and executed over a period of years, to destroy the COMPANY." (R 133)

Shortly after the Individual Defendants made their motion, the Trustee moved likewise for an order:

" . . . under Rule 42(b) F.R.C.P. separating the trial of plaintiffs' first and second causes of action from the trial of the 'First Counterclaim' of defendant Ackman and the two counterclaims of said three individual defendants." (R.138)

Buchman opposed both motions in all respects. By its decision and order of May 9, 1967 (80a), Judge Cooper denied the Individual Defendants' summary judgment motion and also denied their alternative motion and the Trustee's motion "to sever plaintiffs' causes of action from the defendants' causes of action from the defendants' counter-claim". He held that:

> "At this point in these proceedings the record does not indicate that the advantages claimed by defendant outweigh the value of having the jury grasp all implications of the involved and somewhat bitter transactions that are the source of this litigation." (underscoring supplied) (81a, 82a)

In late 1967 and in early 1968, counsel for all parties were nearing the end of the complex discovery proceedings in this action, addressed primarily to the Conspiracy Claims. During late 1967 and early 1968, there were also a number of pretrial conferences and hearings. Lengthy pretrial memoranda were submitted by counsel for all parties. Buchman's pretrial memorandum repeated his complaint's statement of the Exchange Transaction in terms of his "payment" theory. He added, however, to the Exchange Transaction, allegations of the Pathy-de Montmollin Sale and the Loan Transaction stating each, likewise, in terms of his payment theory.*

*The claim, as thus supplemented, was stated as follows:

On March 5, 1968, the Individual Defendants renewed their motion for summary judgment dismissing the Subordination Claim, or in the alternative, "for a separate

Footnote continued from preceding page:

> "Plaintiffs claim that the individual defendants breached the foregoing provision in the following manner: (as per the amendments to plaintiffs' complaint as herein provided for)
>
> "1. By the defendant ALEXANDER F. PATHY selling to the defendant MARIE LOUISE de MONTMOLLIN on or about June 1, 1957 his Series B debentures in AMERICAN FOAM RUBBER CORPORATION for the sum of $80,000. and receiving such amount from her in payment therefor.
>
> "By causing AMERICAN FOAM RUBBER CORPORATION in or about April or May 1958, in their capacity as officers, directors and stockholders thereof, to amend the Certificate of Incorporation as to provide for 3,500 shares of 5% cumulative preferred stock of the par value of $100.00 and thereafter issuing shares of the preferred stock of AMERICAN FOAM RUBBER CORPORATION to themselves in exchange for and in payment of the debentures then held by the individual defendants.
>
> "By the defendant MARIE LOUISE de MONTMOLLIN being credited on the books of Burlington Holding Corporation, the subsidiary of AMERICAN FOAM RUBBER CORPORATION, in or about April 1 1960 with the receipt of $15,000. and the simultaneous discharge of $15,000. of Burlington debentures then held by her and the simultaneous loan of the same sum of $15,000. by MARIE LOUISE de MONTMOLLIN to AMERICAN FOAM RUBBER CORPORATION." (underscoring supplied) (R 205)

trial, without a jury, of the remaining issues of fact raised by the [Subordination Claim] . . . upon such date, in advance of the trial of the [Conspiracy Claims], as this Court may fix . . . ." Shortly after the Individual Defendants made their second summary judgment motion, however, and during conferences between the Court and counsel for all parties, Judge Cooper suggested to counsel for the Individual Defendants, the principal author of this brief, that the said summary judgment motion be withdrawn, without prejudice, to enable the Court to proceed with trial of the Conspiracy Claims, which he then agreed <u>should</u> be separated from the determination of the Subordination Claim. On March 8, 1968, a stipulation withdrawing the summary judgment motion, without prejudice to a renewal thereof, so ordered by Judge Cooper, was filed (R 146)

On March 15, 1968, a pre-trial order was signed. Paragraph VII b) thereof provided that:

> "b) Defendants' counterclaim [the Conspiracy Claims] shall be tried first to conclusion and then plaintiffs' [Subordination Claim] shall be tried to conclusion." (R 206)

The pre-trial order also set forth a short statement of the issues on both the Conspiracy Claims and the Subordina-

tion Claim, stating the latter as follows:*

> "a) Did the individual defendants by their actions and conduct breach the subordination provisions of the May 17, 1957 agreement entered into by them with Samuel Buchman." (152a)

Shortly after the trial of the Conspiracy Claims, ending in the conspiracy verdict hereinbefore described in the "Statement of the Case", and on May 1, 1968, the Individual Defendants did renew their summary judgment motion to dismiss the Subordination Claim. Their motion papers (R 150) simply incorporated by reference their March 5, 1968 motion papers.

By decision and order dated August 13, 1968, Judge Cooper denied the Individual Defendants' renewed summary judgment motion, and for the second time stated the single issue for trial as that of whether "the transactions complained of might be steps 'in a plan to obtain cash -- or cash realizable property -- from the corporation.'" (R 137)

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* The pre-trial order framed the issues with respect to the Conspiracy Claims as follows:

> "b) Did Buchman conspire with important employees of American Foam Rubber Corporation or its subsidiaries to injure or destroy American Foam Rubber Corporation or the value of the individual defendants' investments therein?
>
> "c) If he did, were acts committed in furtherance of such conspiracy?
>
> "d) What is the pecuniary amount of the damage done to American Foam Rubber Corporation by Buchman's conspiracy?
>
> "e) What is the pecuniary amount of the damage done to the individual defendants by Buchman's conspiracy?" (152a)

(quoting from the Court's earlier decision of May 9, 1967).

Between May, 1968 and November, 1968 there was a profusion of motions by all parties directed to the verdicts and judgment on the Conspiracy Claims. The trial of the Subordination Claim, still slated to be before the Court and a jury, did not commence until December 3, 1968. Shortly before the commencement of the trial the parties agreed to trial of the Subordination Claim without a jury. The Clerk's minutes do not refer to any order providing for non-jury trial, the one relevant entry stating the following:

> "Dec. 3-68 Before, Cooper, J. - Non-Jury trial continued from 4-29-68 - Trial as to pltffs case."(2a)

The recollection of Individual Defendants' counsel is that it was the Court itself which suggested that the jury be waived for the trial of the Subordination Claim. In any event, Individual Defendants' counsel consented thereto believing that the only issue to be tried was the "payment" issue, as refined by the Court in its two denials of the Individual Defendants' summary judgment motion.

It was against this background, of nine years' litigation of the "payment" issue, as refined by the Court, that the District Court, on July 23, 1969, filed its opinion finding for the Individual Defendants on that issue with respect to the Pathy-de Montmollin Sale Transaction and the

Exchange Transaction, but subjecting the Individual Defendants to liability on the Exchange Transaction on the basis of the wholly new theory of law, discussed under the caption "Dividends Paid on Subordinated Debt". (219a)

The interjection by the Court of a new claim and new theory of action by Buchman created a serious gap in Buchman's proof on the trial of the action, he having rested without any proof of any damages under a claim and theory of action which he never pleaded. Nor did he move to conform the pleadings to the proof, because his highly competent counsel knew that the proof did conform to the pleadings.

The defendants objected strenuously to those portions of the July 23, 1969 opinion which created a new claim and new theory of action and required new proof. They made those objections by another motion, entitled "MOTION FOR SUMMARY JUDGMENT", praying for an order:

> "1. Modifying the said Opinion of this Court so as to: a) eliminate therefrom the Court's findings of fact and conclusions of law pursuant to which liability is imposed upon defendant MRS. de MONTMOLLIN on account of the exchange by said defendant of debentures for preferred stock; and b) eliminate therefrom the direction to the parties, after the closing of the trial, to interpose additional evidence; and
>
> "2. Granting to defendant MRS. de MONTMOLLIN such other and further relief as this Court may deem proper." (R 196)

Simultaneously with their motion of August 5, 1969, as they were required to do, the Individual Defendants submitted

some proof, by way of affidavit, addressed to the issue of Buchman's damages from the "Dividends Paid" breach of the Subordination Claim. Buchman likewise submitted proof by way of affidavit.

On August 25, 1969 the District Court, by endorsement on the Individual Defendants' motion papers, denied their motion of August 5, 1969, and rendered its opinion and findings with respect to the damages suffered by Buchman from the "Dividends Paid" breach of the Exchange Transaction. The opinion, reported at 309 F.Supp. 547, 548, found this case to be "unique", stating the following:

> "This case is unique in that while such damages are highly conjectural today, they can be made certain at some future date." (249 a)

Five years later, and following termination of the AFR bankruptcy proceedings, the District Court did fix the amount of Buchman's damages on the Exchange Transaction and the amount of final judgment, from which this appeal is taken.

The substantial prejudice suffered by the Individual Defendants is self-evident from the detailed and unique history of this action, as set forth above, and that portion of the July 23, 1969 opinion in which the District Court found liability of the Individual Defendants under its new, unpleaded and untried theory relating to the Exchange Transaction. The validty of that theory of liability, as a matter

of the substantive law of contracts and of subordination, is discussed under Points I and II, respectively, of this brief.

If, however, that theory of liability is granted any acceptance, it can only be by applying equitable principles and considerations to the evidence before the Court on the trial of the Subordination Claim. Dodge-Freedman, supra; Cherno, supra. To the extent that any equitable considerations are deemed to govern the rights and duties of the parties, the Individual Defendants were denied their right to have the proof of Buchman's conspiracy to destroy the business of the Company before a jury, simultaneously with the evidence relating to the Subordination Claim.

It is both ironic and an acute measure of the prejudice suffered by the Individual Defendants, that they, deeming the issue raised by the Subordination Claim to be one of law only, or if not one wholly of law, a very narrow and separable issue of fact, sought a separate trial. The Court denied that motion, holding that it was important that the Conspiracy Claims and the Subordination Claim be tried together, because of "the value of having the jury grasp all implications of the involved and seemingly bitter transactions that are the source of this litigation". (81a, 82a)

Individual Defendants' counsel have searched for a report of a case in which a court followed procedures substantially similar to those followed by the District Court herein. They have found none. It is clear, however, that prejudice substantially less than that suffered by the Individual Defendants herein renders impermissible an amendment of pleadings after trial. Ricciutu v. Voltarc Tubes, Inc., 277 F.2d 809 (2d Cir. 1960). Had Buchman himself moved to amend the pleadings to raise the new theory of his claim, it would have been an abuse of discretion for the District Court to grant the motion. See Strauss v. Douglas Aircraft Co., 404 F.2d 1152 (2d Cir. 1968); United States v. 47 Bottles, More or Less, etc., 320 F.2d 564 (3d Cir. 1963). The District Court's amendment of the pleadings, sua sponte, is similarly impermissible.

Concededly, the question of whether or not to allow the amendment of a pleading lies within the discretion of the Court. However:

> "This discretion, while quite broad, is not unlimited and cannot be exercised in a manner as to result in substantial prejudice to a party." United States v. 47 Bottles, More or Less, etc., supra, at 573 (underscoring supplied).

The District Court, in requesting that the parties submit additional evidence in respect to damages after the conclusion of the trial and its entry of Findings of Fact

and Conclusions of Law, improperly reopened the action after it had been closed. There is no doubt of the power of a District Court, in a proper case and under proper circumstances, to reopen the record of evidence after it has been closed. Reconstruction Finance Corp. v. Commercial Union of America Corp., 123 F. Supp. 748 (S.D.N.Y. 1954). Such power is to be exercised, however, only in a case in which the evidence is clearly within the issues, and when the party seeking such reopening proves himself entitled to it and moves promptly.

The Court of Appeals for the Eighth Circuit in Arthur Murray, Inc. v. Oliver, 364 F.2d 28 (8th Cir. 1966) has described the standard for exercise by a trial court of the power to reopen a case on the Court's own motion:

> "A court has, of course, the general power to reopen a case, either on motion of a party or on its own motion, while the matter is still under advisement, for the receipt of further evidence."
>
> * * * *
>
> "But this may not be taken to imply that a court is entitled to engage free-handedly in adding evidence to a record on its own motion. In the spirit of our adversary system, it is not the business of a court to make additions of evidence in a submitted case on its own motion other than as there may be some element of such probative importance that its addition will prevent a miscarriage of justice from occurring in the situation." Id. at 34 (underscoring supplied)

In Schuber v. S.S. Kresge Company, 458 F.2d 1058 (3d Cir. 1972), the Court dealt with the question of prejudice caused by reopening under circumstances similar to those present here:

> "... It should certainly have been prejudicial to defendant to allow the introduction of this entirely new evidence. ... [T]he events are five years old and defendant has been preparing his defense in accordance with the original theory developed by plaintiff[s] during the pretrial and trial stages." Id. at 1060

In this case the District Court's reopening of the case on its own motion was accomplished without a showing that any miscarriage of justice would occur and without consideration of the prejudice to the Individual Defendants. Moreover, there was no showing by Buchman that the evidence required was not available at the time of the trial. This, in and of itself, would have justified denial of a motion by him to reopen. Central & So. Motor Frgt. Tariff Ass'n v. U.S., 345 F. Supp. 1389 (S.D.N.Y. 1972).

The District Court, in its July 1969 opinion, abandoned its own thrice declared law of the case without any justification for doing so. Concededly, the doctrine of the law of the case is a flexible one. Messenger v. Anderson, 225 U.S. 436 (1912). Thus, a federal court is not bound by its prior decision in a particular case in the

same manner as it would be bound by the doctrine of res judicata. The flexibility of the law of the case doctrine does not mean that there are no standards by which its applicability is measured. Thus, in Warton v. Hirsch, 348 F.2d 906 (2d Cir. 1965), this Circuit stated that the law of the case should be followed:

> "... nless there are compelling reasons presented for the Court to reverse its prior decision." Id. at 907

In the instant action there were no compelling reasons presented to justify the District Court's abandonment of its law of the case. In its May 1967 opinion, the District Court neither "...committed an error which results in injustice", nor laid "... down a principle of law for future guidance which is unsound and contrary to the interests of society." Johnson v. Cadillac Motor Car Co., 261 F. 878, 886 (2d Cir. 1919). The abandonment of the law of the case created rather than prevented injustice. The Individual Defendants, having relied upon the law of the case in the formulation of their trial strategy,were substantially prejudiced by the District Court's after-trial abandonment of it to find for Buchman on a theory of law neither pleaded nor proven by him.

Order of procedure and justice require reversal of the District Court's finding of liability of the Individual Defendants under the Exchange Transaction.

CONCLUSION

For all of the foregoing reasons, the judgment of the District Court appealed from should be reversed and judgment entered in the Individual Defendants' favor dismissing the complaint herein, and awarding costs of this appeal to them.

Dated: New York, New York

April 2, 1975

Respectfully submitted,

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376—Affidavit of Service by Mail

United States Court of Appeals
For the Second Circuit

The Reporter Co., Inc., 11 Park Place, New York, N. Y. 10007

First National Bank of Hollywood, Dorothy Buchman et al.

Plaintiffs-Appellees

against

American Foam Rubber Corp. et al.

Defendants

Mario Louise et al.

Defendants-Appellants

AFFIDAVIT OF SERVICE BY MAIL

State of New York, County of New York, ss.:

Raymond J. Braddick, agent for Winer Neuberger & Sive, being duly sworn deposes and says that he is the attorney herein. That he is over 21 years of age, is not a party to the action and resides at Levittown, New York

That on the 4th. day of April, 1975, he served the within

Exhibit Volume, Appendix and Brief

Dorothy Buchman
As Executrix of the Estate of Samuel Buchman Pro Se
3180 South Ocean Drive
Hallandale, Florida 33009

upon the attorneys for the parties and at the addresses as specified below

Dorothy Buchman, Executrix of the Estate of Samuel Buchman et al.

by depositing 3 copies of each to each of the same securely enclosed in a post-paid wrapper in the Post Office regularly maintained by the United States Government at

90 Church Street, New York, New York

directed to the said attorneys for the parties as listed above at the addresses aforementioned, that being the addresses within the state designated by them for that purpose, or the places where they then kept offices between which places there then was and now is a regular communication by mail.

Sworn to before me, this 4th. day of April, 19 75

Raymond J. Braddick

ROLAND W. JOHNSON
Notary Public, State of New York
No. 4509705
Qualified in Delaware County
Commission Expires March 30, 19 77